

Internal Revenue Service  
**memorandum**

CC:TL:Br2  
JMPanitch

date: APR 30 1987  
to: District Counsel, Chicago CC:CHI  
Attn: Judith M. Picken  
from: Director, Tax Litigation Division CC:TL

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subject: [REDACTED]

This memorandum responds to your written request for technical advice, dated April 8, 1987.

Brief Statement of Facts

X corp. was a wholly-owned subsidiary of Exempt Organization (EO). EO did not acquire X corp.'s stock by purchase. On [REDACTED], X corp. and Third-Party executed a contract for the sale of X corp.'s sole asset, an apartment building, for \$ [REDACTED] consisting of \$ [REDACTED] in cash and a note for \$ [REDACTED]. X corp.'s adjusted basis in the apartment building was \$ [REDACTED]. Third-Party agreed to pay off the \$ [REDACTED] balance on a note secured by the property and held by Bank. On [REDACTED], EO voted to liquidate X corp. On [REDACTED], X corp. and Third-Party closed the sale of the apartment building. On [REDACTED], X corp. liquidated, distributing the cash and note to EO.

Issue

Since § 514(d) 1/ would have determined EO's basis in the apartment building if X corp. had distributed the apartment building to EO, does X corp. recognize gain on the sale to Third-Party, or does § 337 accord X corp. nonrecognition?

Analysis

A. Summary

Section 514(d) would have determined EO's basis in the apartment building if X corp. had distributed the building to EO in the § 332 liquidation. But X corp. sold the apartment building to Third Party and EO only received cash and a note whose bases carried over from X corp. per § 334(b)(1). Therefore, § 337(c)(2)(A), which was enacted specifically to prevent the type of

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1/ Unless otherwise stated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during [REDACTED].

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treatment EO is requesting, prevents X corp. from receiving S 337(a) nonrecognition treatment on the sale to Third Party.

B. DISCUSSION

Section 332 provides in pertinent part:

(a) GENERAL RULE.--No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

(b) LIQUIDATIONS TO WHICH SECTION APPLIES.--For purposes of subsection (a), a distribution shall be considered to be in complete liquidation only if--

(1) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends); and either

(2) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the shareholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution;... .

Section 334(b)(1) provides:

IN GENERAL.--If property is received by a corporation (within the meaning of section 332(b)), then, ..., the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor.

... .

Section 337 provides in pertinent part:

(a) GENERAL RULE.--If, within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

...

(c) LIMITATIONS.--

...

(2) LIQUIDATIONS TO WHICH SECTION 332 APPLIES.--In the case of a sale or exchange following the adoption of a plan of complete liquidation, if section 332 applies with respect to such liquidation, then--

(A) if the basis of the property of the liquidating corporation in the hands of the distributee is determined under section 334(b)(1), this section shall not apply;... .

Reg. § 1.337-2 provides in pertinent part:

Sales or exchanges within the scope of section 337.--(a) Provided the other conditions of section 337 are met, sales or exchanges which occur on or after the date on which the plan of complete liquidation is adopted and within the 12-month period thereafter are subject to the provisions of such section. The date on which a sale occurs depends primarily upon the intent of the parties to be gathered from the terms of the contract and the surrounding circumstances. In ascertaining whether a sale or exchange occurs on or after the date on which the plan of complete liquidation is adopted, the fact that negotiations for sale may have been commenced, either by the corporation or its shareholders, or both shall be disregarded. Moreover, an executory contract to sell is to be distinguished from a contract of sale. Ordinarily, a sale has not occurred when a contract to sell has been entered into but title and possession of the property have not been transferred and the obligation of the seller to sell or the buyer to buy is conditional.

Section 514 provides in pertinent part:

(a) UNRELATED DEBT-FINANCED INCOME AND DEDUCTIONS.--In computing under section 512 the unrelated business taxable income for any taxable year--

(1) PERCENTAGE OF INCOME TAKEN INTO ACCOUNT.--There shall be included with respect to each debt-financed property as an item of gross income derived from an unrelated trade or business an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as (A) the average acquisition indebtedness (as defined in subsection (c)(7)) for the taxable year with respect to the property is of (B) the average amount (determined under regulations prescribed by the Secretary) of the adjusted basis of such property during the period it is held by the organization during such taxable year.

...

(b) DEFINITION OF DEBT-FINANCED PROPERTY.--

(1) IN GENERAL.--For purposes of this section, the term "debt-financed property" means any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (c)) at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition), ... .

...

(c) ACQUISITION INDEBTEDNESS.--

(1) GENERAL RULE.--For purposes of this section, the term "acquisition indebtedness" means, with respect to any debt-financed property, the unpaid amount of--

(A) the indebtedness incurred by organization in acquiring or improving such property;

...

(2) PROPERTY ACQUIRED SUBJECT TO MORTGAGE, ETC.--For purposes of this subsection--

(A) GENERAL RULE.--Where property (no matter how acquired) is acquired subject to a mortgage or other similar lien, the amount of the indebtedness secured by such mortgage or lien shall be considered as an indebtedness of the organization incurred in acquiring such property even though the organization did not assume or agree to pay such indebtedness.

(7) AVERAGE ACQUISITION INDEBTEDNESS.--for purposes of this section, the term "average acquisition indebtedness" for any taxable year with respect to a debt-financed property means the average amount, determined under regulations prescribed by the Secretary, of the acquisition indebtedness during the period the property is held by the organization during the taxable year, except that for the purpose of computing the percentage of any gain or loss to be taken into account on a sale or other disposition of debt-financed property, such term means the highest amount of the acquisition indebtedness with respect to such property during the 12-month period ending with the date of the sale or other disposition.

(d) BASIS OF DEBT-FINANCED PROPERTY ACQUIRED IN CORPORATE LIQUIDATION.--For purposes of this subtitle, if the property was acquired in a complete or partial liquidation of a corporation in exchange for its stock, the basis of the property shall be the same as it would be in the hands of the transferor corporation, increased by the amount of gain recognized to the transferor corporation upon such distribution and by the amount of any gain to the organization which was included, on account of such distribution, in unrelated business taxable income under subsection (a).

Reg. § 1.514(d)-1 provides:

BASIS OF DEBT-FINANCED PROPERTY ACQUIRED IN CORPORATE LIQUIDATION.--(a) If debt-financed property is acquired by an exempt organization in a complete or partial liquidation of a corporation in exchange for its stock, the organization's basis in such property shall be the same as it would be in the hands of the transferor corporation, increased by the amount of gain recognized to the transferor corporation upon such distribution and by the amount of any gain which is includable, on account of such distribution, in the gross income of the organization as unrelated debt-financed income.

Section 512 provides in pertinent part:

(a) DEFINITION.--For purposes of this title--

(1) GENERAL RULE.--Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

...

(b) MODIFICATIONS.--The modifications referred to in subsection (a) are the following:

(4) Notwithstanding paragraph ...  
(5), in the case of debt-financed property (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2).

(5) There shall be excluded all gains or losses from the sale, exchange, or other disposition of property ... .

Section 513(a) provides:

GENERAL RULE.--The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)), ... .

The requirements of § 332 are met in this case: X corp. was a wholly-owned subsidiary of EO throughout the relevant periods, and the distribution in complete cancellation of X corp.'s stock occurred within one year of the adoption of the plan of liquidation. Thus, EO recognized no gain upon the receipt of cash 2/ and a note 3/ in exchange for the X corp. stock.

It appears that EO did not acquire its X corp. stock by purchase. Thus, since § 334(b)(1) generally determines the basis of property received in the liquidation of an 80%-or-more owned subsidiary, we would expect X corp.'s basis in the cash and note to carry over to EO. Although

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2/ EO has conceded and the facts indicate that X corp., not EO, sold the apartment building. Thus, EO received cash and a note from X corp. when X corp. liquidated. Our conclusions would be different if it could be proven that EO received the apartment building in kind and that EO, and not X corp., sold the building to Third Party. Under these circumstances, EO would recognize the gain from the sale of the apartment building, and approximately 50% of such gain (\$ [REDACTED] Acquisition Indebtedness/\$ [REDACTED] Adjusted Basis) would be included in EO's unrelated business taxable income per § 512(a)(1), (b)(4)+(b)(5) and § 514.

3/ Despite X corp.'s receipt of a note for \$ [REDACTED] upon the sale of the apartment building, the installment sale provisions of § 453 do not apply, because the cash X corp. received in the sale amounted to more than 30% of the selling price. § 453(b).

the requirements of § 337(a) are satisfied here 4/, if the basis of the cash and notes EO received are determined under § 334(b)(1), § 337(c)(2)(A) would prevent X corp. from receiving § 337(a) nonrecognition treatment. 5/

EO contends, however, that § 337(a) prevented X corp. from recognizing gain on the sale of the apartment building: EO reasons that if X corp. had distributed the apartment building in liquidation to EO instead of selling it, the apartment building would be "debt-financed property" per § 514(b) in EO's hands; and that therefore § 514(d) and not § 334(b)(1) would determine EO's basis in the apartment building, preventing the application of § 337(c)(2)(A). 6/

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4/ X corp.'s execution of the contract of sale of the apartment building to Third Party prior to EO's adoption of a plan to liquidate X corp. does not prevent the application of § 337(a), since the sale was not closed until after EO adopted the plan to liquidate X corp. Reg. § 1.337-2.

5/ Without § 337(c)(2)(A), an 80%-or-more owned subsidiary would escape taxation upon its sale of property pursuant to a plan of complete liquidation by falling under the general rule of § 337(a). The gain potential inherent in the property could not be preserved by giving the parent a carry-over basis in the cash the parent received from the liquidating subsidiary. Thus, the parent would escape taxation on the potential gain as well. Hence, even though the property had been disposed of outside of corporate solution, the gain would escape taxation.

6/ EO would have taken the apartment building subject to a mortgage of \$[REDACTED]. Section 514(c)(2)(A) would treat the mortgage as an indebtedness which EO incurred in acquiring the property. Thus, the mortgage would be an "acquisition indebtedness" within § 514(c)(1)(A). Since the mortgage securing payment of the loan incurred to acquire the apartment building would be an "acquisition indebtedness," the apartment building would be "debt-financed property." § 514(b). EO would receive a carryover basis of approximately \$[REDACTED]. § 514(d). Assuming for the sake of simplicity that the debt/basis ratio was 50%, upon later sale of the apartment building, 50% of the taxable gain would be considered unrelated business taxable income. § 514(a), § 512(b)(4) and (b)(5).



But what might have happened is irrelevant. X corp. did not distribute the property to EO in kind, but rather X corp. sold the apartment building to Third Party. Indeed § 337(c)(2)(A) was intended to protect against the result EO unwittingly argues for here 1/: although the potential gain inherent in the apartment building could not be adequately preserved, X corp. would receive nonrecognition treatment.

Another argument EO might make to persuade a court that § 337(a) applies to X corp.'s sale of the apartment building to Third Party is that § 514(d) speaks only of property generally, and not specifically of debt-financed property; thus, any property received in the liquidation of X corp. would be determined under § 514(d), and § 337(c)(2)(A) would not apply.

As appealing as this argument might seem at first glance, under closer inspection its several flaws are clear:

1. Added to the Internal Revenue Code in 1969, § 514(d) was intended to prevent an exempt organization from acquiring debt-financed property through a corporation which would shelter income thrown off by the property with depreciation deductions, use the income to reduce the amount of the debt, and then liquidate. The liquidating corporation would receive no gain due to § 336, and the exempt organization would recognize no gain upon receipt of the distribution in liquidation, despite the language of § 331, because it is an exempt organization. § 334(a) would give the exempt organization a stepped up basis in the property, and since the taxable corporation had reduced the debt secured by the property, the debt/basis ratio would be relatively low. With a low debt/basis ratio, very little of the income thrown off by the property would be subject to tax as income from an unrelated trade or business. Thus, Congress enacted § 514(d) to prevent an abuse specific to § 514.

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1/ EO's position here is not unabashedly gluttonous, since EO argues that it, and not X corp., should be taxed upon the gain. As detailed above, the tax on the parent should be approximately 50% of the tax the subsidiary would otherwise have to pay on the gain.

2. Section 514(d) is found as a subsection of a section which deals with debt-financed property. Section 514(d) speaks of "the property," not just "property," suggesting that it is referring to specific property recently discussed. Subsections (a), (b) and (c) of § 514 specifically discuss debt-financed property, and therefore, "the property" in § 514(d) must refer to "debt-financed property" received by the exempt organization.

3. Reg. § 1.514(d)-1 specifically refers to "debt-financed property."


Since § 514(d) can only be interpreted to apply to "debt-financed property" received by EO in the liquidation distribution, § 334(b)(1) and not § 514(d) determines the basis of the cash and note EO received from X corp.

#### C. CONCLUSION

Section 514(d) would have determined EO's basis in the apartment building if X corp. had distributed the building to EO in the § 332 liquidation. But X corp. sold the apartment building to Third Party, and EO only received cash and a note, whose bases carried over from X corp. per § 334(b)(1). Therefore, § 337(c)(2)(A), which was enacted specifically to prevent the type of treatment EO is requesting for X corp., prevents X corp. from receiving § 337(a) nonrecognition treatment on the sale to Third Party.

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